LITIGATION – FACT OR FICTION

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Litigation – Fact or Fiction

I. Exhaustion of Administrative Remedies

A. Under California judicial authorities, failure to exhaust administrative remedies is a jurisdictional procedural defect which bars court action. *Shiseido Cosmetics (America) Ltd.* v. *Franchise Tax Board* (1991) 235 Cal.App.3rd 478; *Aronoff* v. *Franchise Tax Board* (1963) 60 Cal.2d 177; *United States Steel Corp.* v. *Franchise Tax Board* (1983) 144 Cal.App.3rd 473; and *Barnes* v. *State Board of Equalization* (1981) 118 Cal.App.3rd 994. The State Board of Equalization (SBE) has indicated a willingness to apply failure to exhaust criteria in determining administrative cases as well. *Appeal of Beneficial California, Inc.*, Feb 22, 1996.

B. Variations of the failure to exhaust jurisdictional issue.

1. Failure to file a claim for refund. *Shiseido Cosmetics (America) Ltd.* v. *Franchise Tax Board* (1991) 235 Cal.App.3rd 478. Section 19382 of the California Revenue and Taxation Code limits a suit for refund to " . . . the ground set forth in [the] claim for refund." If there is no claim, there can be no lawsuit. (An exception is to be noted in the case of a determination of residency as provided for by Section 19381 Revenue and Taxation Code.)

2. Grounds not specifically stated. "The claim for refund delineates and restricts the issues to be considered in a taxpayer's refund action. *King* v. *State Board of Equalization* (1972) 22 Cal.App.3rd 1006; *Atari Inc.* v. *State Board of Equalization* (1985) 170 Cal.App.3rd 665; and *Jimmy Swaggart Ministries* v. *State Board of Equalization* (1988) 204 Cal.App.3rd 1269.

   A court must interpret the language in the claim to determine whether an issue not specifically stated is encompassed within a general statement.

   Special care should be exercised in the circumstances where a protest or an appeal of a deficiency assessment has been converted to a claim by payment while the matter is pending. The original protest or appeal becomes the claim.

   An additional issue that might arise is whether it is the original document which controls or whether subsequent submissions by the taxpayer can modify the original document either by expansion or by limitation.

3. Failure to respond to requests for information at the administrative level. *United States Steel Corp.* v. *Franchise Tax Board* (1983) 144 Cal.App.3rd 473; and *Barnes* v. *State Board of Equalization* (1981) 118 Cal.App.3rd 994.

   This circumstance appears directly related to the judicially created doctrine of exhaustion of administrative remedies which evolved to promote comity between coequal branches of government and to relieve overburdened courts from the need to deal with cases where effective administrative remedies are available.

   The judicial doctrine of exhaustion of administrative remedies has judicially created exceptions such as no effective remedy, agency without jurisdiction, known decision of the agency, constitutional issues, etc. See Witkin, Actions, §§ 234, et seq. The courts have not applied these exceptions in the tax setting, ostensibly because application of the administrative exhaustion doctrine in the tax setting is compelled by the constitutional grant of power to the Legislature to prescribe the manner of proceeding in contesting taxes. *Patane* v. *Kiddoo* (1985) 167 Cal.App.3rd 1207.

II. State Board of Equalization Decisions as Judicial Precedent

Over the decades, while acting as the state's final administrative tribunal with respect to taxes administered by Franchise Tax Board (FTB), SBE has issued a number of decisions interpreting statutes and statutory schemes. Such decisions have involved issues such as the propriety of penalties authorized by specific statutes, the Joyce/Finnegan/Huffy saga, and the standards for filing as a unitary business. SBE has intended that such decisions have precedence and "apply the standards required by judicial opinions," and such decisions have been relied upon by FTB in tax refund actions. (See, e.g., *Mole-Richardson Co.* v. *FTB* (1990) 220 Cal.App.3d 889 (fn. 2).)

SBE also makes specific decisions, as a Board, in response to claims for refund for sales and use taxes.

In *Yamaha* v. *SBE* (1998) 19 Cal. 4th 1, the California Supreme Court reaffirmed its position that "the ultimate interpretations of a statute is an exercise of the judicial power."

As opposed to lawsuits challenging a formal regulation adopted by SBE, for which lawsuits there is a body of law generally applicable to judicial review of the promulgation of regulations issued by an administrative agency, the questions for taxpayers, and for FTB and SBE, include 1) the precedential effect or deference, if any, which California courts are obligated to give to SBE decisions; and

2) whether a lone taxpayer, disgruntled with SBE precedent otherwise approved or accepted by an industry, can obtain a judicial decision which effectively overturns long-standing SBE interpretations of statutory provisions.

III. Penalties in Tax Cases

Dicta in the California Supreme Court's recent decision in *Agnew v. State Board of Equalization* (1999) 21 Cal. 4th 310, suggests that penalties may not be required to be paid before a tax refund action may be maintained.

Prior to the *Agnew* decision, the position of the California taxing agencies was that tax, penalties and interest must be paid as a condition of filing a valid refund claim, a prerequisite to suit. *Agnew* held that interest need not be paid as a prerequisite to filing a tax refund suit. Cal. Const. Art. XIII, Section 32, deprives a court of jurisdiction only to prevent or enjoin the collection of any "tax." Similarly, Revenue and Taxation Code section 6931, the Sales and Use Tax Law statutory anti-injunction provision, provides that a court may not prevent collection of a "tax". The *Agnew* Court distinguished cases such as *Weston Inv. Co. v. State of California* (1948) 32 Cal. 2d 390, and *Sonleitner v. Superior Court* (1958) 58 Cal.App.2d 258, which held that penalties are part of the tax for collection purposes, on the ground those cases did not consider whether for purposes of the prepayment requirement the Legislature intended that interest (or penalties) be deemed a part of the tax.

The *Agnew* case creates procedural uncertainties with respect to a taxpayer's challenge to penalties. Rev. and Tax. Code section 19802(a) (applicable to the Personal Income Tax and the Bank and Corporation Tax), and *Pope Estate Co. v. Johnson* (1941) 43 Cal. App. 2d 170, provide that all claims for a single tax year must be litigated in one case or face the bar of *res judicata*. *Agnew* suggests that a taxpayer may seek prepayment injunctive relief for penalties in a tax refund action. However, the case also suggests that the state may collect penalties or assert penalties as an offset to potential tax refunds.

Unaddressed by the *Agnew* case, and more troublesome, are the requirements of the exhaustion of administrative remedies doctrine as applied to penalties. In many cases, penalties may be excused for reasonable cause or are inapplicable if the taxpayer makes certain factual showings. Must a taxpayer apprise taxing agencies of these independent grounds for challenging the penalties as a prerequisite to litigating its liability for these sums?

Attachment 1 is a chart that lists some of the civil penalty sections of the Sales and Use Tax Law, Personal Income Tax Law, and the Bank and Corporation Tax Law which might have independent grounds, such as reasonable cause, for challenging a penalty assessment.

Attachment 2 is a chart listing 1997 and 1998 appeals to the State Board of Equalization that include penalty challenges:

IV. Case Summaries

A. Procedural Issues.

The Full Payment Rule - *Agnew* v. *State Board of Equalization* (1999) 21 Cal 4th 310.

The taxpayer purchased interests in two thoroughbred racehorses in two separate transactions. With respect to the first transaction, the taxpayer paid the tax and interest. An action was brought with respect to this transaction seeking a declaration that interest did not need to be paid prior to bringing an action claiming a refund and asking for a segregation or return of the interest paid. With respect to the second transaction, the taxpayer paid only the tax prior to bringing an action.

The Board demurred to the taxpayer's complaint upon the basis that the taxpayer failed to exhaust his administrative remedies prior to bringing the action for declaratory relief. The trial court sustained the demurrer.

The Court of Appeal reversed. It concluded that nothing in the constitutional or statutory provisions required payment of accrued interest, in addition to the tax, as a prerequisite to either the review of a claim for refund by the Board, or as a prerequisite to filing an action in the Superior Court for a declaration of the legality of the Board's *de facto* policy requiring payment of both tax and accrued interest as a prerequisite to taking action on the taxpayer's claim for refund. The California Supreme Court affirmed.

The appellate court accepted the taxpayer's claim that his declaratory relief action was not barred by either the constitutional or statutory provisions because the lawsuit did not impede or prevent the collection of taxes. The court observed that the taxpayer had already paid the claimed tax deficiencies and the declaratory relief action clearly does not "prevent or enjoin" the collection of taxes.

The Supreme Court, in its opinion, first held that because the taxpayer was not seeking a declaration as to the validity of the taxes, there was no requirement that the Board act on the claim for refund as a prerequisite to bringing the action.

Next the court ruled that the Board's administrative practice of requiring prepayment was entitled no deference because it had not been adopted

as a regulation, and there was no claim of long-standing administrative practice.

On the merits, the court found that the constitutional provision unambiguously states that an action may be maintained after the payment of "a tax claimed to be illegal" and makes no mention of interest. The court went on to conduct a long, and thorough, historical analysis of article XIII, section 32, and the statutes in response to arguments advanced by the state that the word "tax" encompassed interest. The court rejected all of these arguments.

Two issues which are not before the court, and which may have continuing interest are 1) whether there is a requirement that penalties be paid before a refund action can be maintained, and 2) whether a challenge to either the assessment of a penalty or interest requires a prepayment of the amounts being challenged.

Additional issues remain, including the interaction of the normal statute of limitations for bringing a claim for refund, and the exception related to the date of payment, and the *Pope Estate* rule.

Date for Filing a Lawsuit - *Adelberg* v. *Franchise Tax Board*, Los Angeles Superior Court BC 131679.

The trial court has held that the Franchise Tax Board must establish the date on which it mailed a notice of action to prove that a taxpayer did not file their lawsuit within the 90-day period provided by statute. Permission to file an appeal has been granted.

Necessity for Examining a Return - *Wertin* v. *Franchise Tax Board*, 68 Cal.App.4th 961.

In October of 1992, the IRS notified the taxpayers that adjustments that had been made to their 1983 return were final. The taxpayers notified the FTB of those changes by letter dated December 18, 1992. The FTB asked for additional information on January 12, 1993, including their state tax return for that year. The taxpayers replied by letter dated January 27, 1993, indicating that the return had been timely filed, that the FTB should have it, and that their copy was in storage. By letter dated May 4, 1993, the FTB advised the taxpayers that their responses were incomplete and the FTB no longer had a copy of their return. The taxpayers responded on May 20, 1993, indicating they would attempt to retrieve their return.

On June 11, 1993, the FTB issued an NPA using its electronic records. The period for issuing an NPA would have expired on or about June 18, 1993. A protest was filed on the basis that FTB had not issued a valid

notice of proposed assessment within six months of the notifying the FTB of the federal changes. Ultimately a copy of the 1983 return was submitted, and the NPA was revised based upon the copy of the return.

The taxpayers filed a claim for refund and instituted a suit for refund. The trial court held, and the appellate court agreed, that there could not be a valid deficiency issued without an examination of the taxpayers' return. See Section 19032 and 19033 Rev. & Tax. Code.

The courts also held that the Wertins were entitled to recover attorney fees because the FTB position was not substantially justified in light of the fact that it knew the Wertins had a copy of the return, had the power to obtain the return, and could have requested a waiver of the statute of limitations pending receipt of the return.

B. Use Tax.

Déjà vu - Yamaha Corporation of America v. State Board of Equalization (1999) 73 Cal App 4th 338.

Yamaha made gifts of musical instruments to various artists. The gifts were made from the inventory maintained in California to non-California residents. Delivery by Yamaha was made to a common carrier in California. The Board of Equalization asserted that the gift was subject to a California use tax.

The appellate court reversed a trial court determination in favor of the taxpayer relying upon annotations in the Business Taxes Law Guide issued by the State Board of Equalization. The California Supreme Court reversed, holding that the annotations were not authoritative. On remand, the appellate court reaffirmed its holding, placing reliance on the reasoning set forth in the annotations and on its own independent analysis.

The court held that the making of a gift was a "use" of the property and that delivery of the gift to a common carrier in this state for delivery out of this state was a use in California. As long as the donor acts unequivocally to show that it intended to divest itself of ownership in the property, the gift is upheld.

The court held that its conclusion did not violate the commerce clause, specifically the fair apportionment clause of *Complete Auto,* because the risk of multiple taxation was reduced or eliminated by the Multistate Tax Compact.

C. Business Income Cases.

Polaroid Corporation v. *Offerman* (1998) 349 N.C. 290, 507 S.E. 2d 284, cert. denied.

Polaroid sued Eastman Kodak to enjoin infringement of various patents and to recover damages. Polaroid won. It was awarded damages for lost profits of $233 million and an additional $204 million for lost profits on royalties. Interest in the amount of $436 million was also awarded.

Polaroid reported the damages as nonbusiness income allocable to Massachusetts, its state of commercial domicile and the state where suit was brought. North Carolina determined that the income was business income.

Polaroid argued that the income arose as the result of an unusual event and not in the regular course of its business, and therefore should not be business income under the UDITPA definition. The state argued, and the North Carolina Supreme Court held that UDITPA contemplates a two-part, transactional and functional, test for determining business income. The transactional test focuses on the frequency and regularity of the transaction for the business. The second clause of UDITPA focuses on the nature of the asset involved in the transaction. Frequency and regularity of transactions is not relevant. The North Carolina Supreme Court's decision is a thorough exposition of the arguments and history of UDITPA.

The decision that damages from a lawsuit to recover items which would have been business income does not appear to be surprising. Consideration should be given to the sales factor issues, which were not discussed in the North Carolina opinion.

Union Carbide Corporation v. *Offerman* (1999) 513 S.E. 2d 341.

Union Carbide adopted a restructuring plan, which included a reversion of a defined-benefit pension plan so the plan's excess assets could be captured by the corporation. Gain of approximately $500 million was realized. The taxpayer reported the gain as nonbusiness income, and North Carolina treated it as business income. The North Carolina appellate court sustained the taxpayer's position. The North Carolina Supreme Court remanded the case for reconsideration in light of its decision in *Polaroid*. The appellate court reanalyzed the case and reaffirmed its holding that the gain was nonbusiness income. The decision was based on the perceived lack of an ownership interest in the pension fund assets and the conclusion that the existence of a pension

fund was not essential to the taxpayer's business. The tax administrator has filed a new appeal with North Carolina Supreme Court.

Hoechst Celanese Corporation v. *Franchise Tax Board*, Court of Appeal, 3rd Dist. C030702.

The taxpayer realized gain, $300 million, on the termination of an employee pension plan. The trial court sustained the FTB determination that the gain constituted business income. The trial court decision is fairly lengthy, thorough, and well reasoned. Appellate briefing has been completed. It is likely that this case will turn on the question of whether there are two tests for determining whether there is business income.

Robert Half International, Inc. v. *Franchise Tax Board* (1998) 66 Cal.App.4th 1020, 67 Cal.App.4th 467.

As part of an acquisition\merger accomplished in January of 1980, the taxpayer issued a warrant which entitled the holder to purchase shares at a set price that created the potential for a substantial minority interest. In February of 1981, the taxpayer paid $7.5 million to repurchase and cancel the warrant. The taxpayer was domiciled in California and treated the cost of the repurchase as a nonbusiness expense allocable to California. The FTB determined that the expense should have been treated as a business item and included in apportionable income. The parties stipulated that UDITPA contemplated a two-part test, functional and transactional, to determine whether an item should be classified as business or nonbusiness.

The appellate court reversed the trial court and held that the acquisition of a warrant was not part of the taxpayer's *regular* trade or business (court's emphasis). The appellate court focused on the extraordinary and non-recurring nature of the event and found that it could not be part of the taxpayer's regular business. In a subsequent modification of the opinion, the court inserted a footnote, which indicated that no opinion was expressed as to whether the sale of property used in its regular trade or business operations should be characterized as business or nonbusiness. It also expressed no view on whether the infrequency or extraordinary nature of the transaction was irrelevant.

D. Commerce Clause Cases.

Interest Offset - *Hunt-Wesson* v. *Franchise Tax Board*, United States Supreme Court Docket 98-2043, and *F.W. Woolworth Co. and Kinney Shoe Corporation* v. *Franchise Tax Board*, United States Supreme Court Docket 98-1967.

The taxpayers incurred interest expense. They also had nonbusiness dividend and interest income. Pursuant to Section 24344(b), Revenue & Taxation Code, the interest expense was first allocated on a dollar-for-dollar basis to business interest income, which is deductible in determining net apportionable income, then on a dollar-for-dollar basis to nonbusiness interest and dividend income, with any residue being deductible in determining net apportionable income. The interest expense allocated to nonbusiness interest and dividend is deductible in determining California net income to the extent such nonbusiness interest and dividend income is taxable by California.

The taxpayers claim that the effect of the statute is to tax indirectly what a state cannot tax directly, the nonbusiness interest and dividend income of a non-domiciliary. They also argue that the operation of the interest offset is discriminatory against interstate commerce.

As an initial matter, it would seem noncontroversial that a state can assign expenses between income which it can consider and income which it cannot consider. Second, it would also seem to be noncontroversial that a state is not required to allow a deduction with respect to expenses which are assignable to an item of income which it cannot consider. The question becomes whether the method of assignment of expenses can give rise to discrimination.

The California appellate courts sustained the interest offset provision in unpublished decisions, and the California Supreme Court declined to review the decisions. The appellate decisions relied on the California Supreme Court's decision in *Pacific Telephone and Telegraph* v. *Franchise Tax Board* (1972) 7 Cal.3rd 544.

The United States Supreme Court granted the certiorari petition in *Hunt-Wesson*. The taxpayer's brief is due on November 12, and the department's brief on December 13. The taxpayer's reply is due on December 30. Argument is anticipated to be scheduled in January.

Deductible Dividends (Insurance) - *Ceridian Corp* v. *Franchise Tax Board* Court of Appeal, 1st Dist. 0A084298-3.

Ceridian, a company domiciled outside of California, received dividends from subsidiaries engaged in the insurance business. Section 24410 of the Revenue and Taxation Code allows a deduction to California-domiciled companies for dividends received from insurance companies to the extent of their activities in California. The amount of the deduction is determined based upon the level of activity in California as measured by a three-factor apportionment formula similar to the three-factor UDITPA apportionment formula.

The trial court held that there was discrimination at several levels. First, the provision of Section 24410 limiting the deductions to domiciliaries discriminated against non-domiciliaries, and, second, the limitation on deductibility to dividends paid from California earnings also discriminated against insurance companies without California earnings. The second issue is based upon the Supreme Court's decision in *Fulton Corporation* v. *Faulkner* (1996) 516 U.S. 325.

The FTB has also raised the issue as to the nature of the proper remedy, a refund or an assessment of tax against those advantaged, citing the following language of Section 19393, Rev. & Tax Code.

> For the purposes of the tax imposed under Chapter 2 of Part 11, if any deduction, credit, or exclusion provided for in Part 10 or Part 11 is finally adjudged discriminatory against a national banking association . . . or is for any reason finally adjudged invalid, or discriminatory . . . the tax of the favored taxpayer shall be recomputed . . . and any difference between the amount of the tax as recomputed and the amount of tax as originally computed shall be subject to the provisions hereof relating to original computations.

The court held that the limitation on relief provided by Section 19393 was not applicable because the statute of limitations for assessing additional taxes had closed for most taxpayers involved in the litigation for the years 1978-1981.

It should be noted that a decision in this case might have some interplay with the constitutionality of Section 24402. The two sections, 24402 and 24411, can be distinguished. Section 24402 relates to deductions within a single tax. Section 24411, as did the deduction in *Fulton*, relates to allowing a deduction because of the assessment of a different tax.

Deductible Dividends (Regular) - *First Credit Bank* v. *Franchise Tax Board*, Los Angeles Superior Court BC205481.

The taxpayer received dividends from other corporations, a portion of whose income had been subjected to California tax. A deduction was claimed under Section 24402 Rev. & Tax. Code with respect to the dividends paid from income which had been taxed by California. The taxpayer brought a suit for refund claiming discrimination because a deduction was not allowed with respect to all of the dividends. This case presents an issue similar to that ruled upon by the United States Supreme Court in *Fulton* v. *Faulkner* (1996) 516 U.S. 325. The two distinctions which exist between this case and *Fulton* are 1) the fact that there is a

single tax involved, and 2) that the deduction is given to prevent double taxation of the same base.

Intrastate Commerce clause - *General Motors Corporation* v. *City and County of San Francisco* (1999) 69 Cal App 4th 448.

San Francisco imposed a tax upon persons who manufacture and sell, or sell, goods through business activities within the city. GM sold products in San Francisco that it manufactured in other cities. The manufacture of goods in the other city was subject to tax.

The court followed a Second District decision with regard to an identical tax imposed by the City of Los Angeles in finding that the difference in tax between those who manufactured and sold and those who sold was discriminatory.

The court refused to allow San Francisco to limit the refund to the amount of taxes which were paid to the city where the manufacturing occurred. The court found that the remedy would not cure the discrimination. The discrimination the court found to exist was between the manufacturer and the seller, not between in-city and out-of-city manufacturers. Furthermore, the court held that requiring the taxpayer to prove the amount of taxes paid seventeen or more years ago gave rise to a less-than-certain remedy.

The court did hold that the taxpayer was not entitled to attorney's fees under federal civil rights law.

E. Combined Reporting.

1. Joyce/Finnigan/Huffy.

Citicorp North America, Inc. v. *Franchise Tax Board,* Court of Appeal, 1st Dist. A086925.

Finnigan in a financial setting. A pure *Finnigan* case with no Public Law 86-272 complications because there is no sale of tangible property involved. Trial was held on October 5, 1998. The case was submitted largely on a Stipulation of Facts and documents. One witness was called to testify that the income involved had been considered by South Dakota in determining its tax.

The trial judge held for the Franchise Tax Board and sustained the application of *Finnigan*.

Deluxe Corporation v. *Franchise Tax Board*, Court of Appeal, 1st Dist.

Finnigan with Public Law 86-272 ramifications. The trial was held in November of 1998 and judgment was entered for the Franchise Tax Board.

2. Tax Credits.

Guy F. Atkinson Company of California v. *Franchise Tax Board*, Court of Appeal, 1st Dist A085075.

Guy F. Atkinson filed as a “key” corporation on a combined report basis including a subsidiary, WBL Solar Corporation. WBL had a solar energy credit of $1,655,489. The taxpayer claimed the credit against the unitary businesses' tax. The FTB at audit determined that the credit was available to only WBL. It was stipulated that WBL was the owner of the credit.

The trial court sustained the position of the FTB that the credit is to be allowed only to an entity. With respect to the solar energy credit, there is a legislative history, amendments making specific that the credit is by entity, supporting entity assignment. The trial court rejected a contention that Section 25137 allowed for the credit to be allocated among various members of the unitary business.

F. Estate Tax.

Hoffman v. *Connell* (1999) 73 Cal App 4th 1194.

Decedent, a resident of California, was the income beneficiary of a testamentary trust established by her husband. California attempted to assert a "pick-up" tax based on the value of the trust property.

The court focused on whether the decedent was the owner of the property. If she was the owner, the property would be required to be included in her estate for California purposes. The court analyzed whether the property would be considered "owned" under federal law, California law, and United States Virgin Islands' law. In all three cases, it concluded that decedent was not the owner of the property.

With respect to federal law, the court concluded that there was no intention for federal estate tax law to determine ownership. For California purposes, the court found that the right to receive income by itself was not sufficient to establish ownership. The court found that United States Virgin Islands law was similar to California's.

The court rejected the state's argument that since the "pick-up" tax only resulted in less money being paid to the federal government and no more tax to the estate, there was no burden to the estate and the "pick-up" tax should be upheld.

G. Proposition 218 Requirement of Two-Thirds Voter Approval.

Howard Jarvis Taxpayers Association v. *City of San Diego* (1999) 72 Cal App 4th 230.

The city adopted a Business Improvement District and levied assessments on businesses to fund property-related improvements and activities. Proposition 218 requires taxpayer approval for the adoption, extension, or increase of taxes or assessments.

The term "assessment" is defined by Proposition 218 to mean a levy or charge upon real property by an agency for a special benefit conferred upon the real property. The assessment at issue in this case was made upon "businesses," not real property, and therefore it was not required to be approved by two-thirds of the voters.

Howard Jarvis Taxpayers Association v. *City of Riverside* (1999) 73 Cal App 4th 679.

The City of Riverside held an election which proposed to continue a Street Light Assessment District. The proposal passed with a vote of fifty percent.

Under Proposition 218, a pre-existing assessment which is not exempt can be re-authorized two ways. First, if it met a "special benefit" requirement, was supported by an engineer's report and received a weighted majority vote. Second, it could be authorized by a two-thirds vote. An exempt assessment is one which is imposed exclusively to finance the capital costs or maintenance and operation expenses for sidewalks, streets, sewers, water, flood control, drainage systems or vector control. Maintenance and operation expenses include the cost of electrical current.

The plaintiffs argued that the assessment was for street lighting, not for sidewalks or streets, and therefore would not be exempt. The court rejected these arguments. The court found that electrical current is necessary to the operation of street lights, which, in turn, is necessary for the operation of sidewalks.

The court refused to find that the fact the city had sought voter approval was a concession by the city that the two-thirds requirement applied.

H. Taxability of Non-California pensions.

Daks v. *Franchise Tax Board* (1999) 73 Cal App 4th 31.

Taxpayer was employed in the state of New York throughout his career. He retired in 1982, and in January of that year elected to receive his pension in the form of 100 monthly payments certain. He moved to California in May of 1982. The FTB assessed taxes on the pension income for the years 1984 through 1987.

The taxpayer claimed that the amounts had accrued prior to his becoming a resident of California and therefore should not be taxed by California under the authority of Section 17554 Rev. & Tax Code. The appellate court did not address the question of whether the pension had accrued prior to Daks becoming a resident of California. It held that Section 17501, which dealt specifically with pension income, controlled over the more general Section 17554.

I. Bundled Software.

Hahn v. *State Board of Equalization* (1999) 73 Cal App 4th 985.

In 1972 the Legislature enacted Section 995 of the Revenue and Taxation Code to provide that computer programs would be exempt from personal property taxation unless they were part of the basic operation system of the computer. The rule has been interpreted to exempt from taxation all computer software programs except those "bundled" with the computer.

In 1995, Orange and several other counties sent notices of additional assessment for "unbundled" computer programs. The State Board of Equalization held hearings on the question and amended Rule 152 in 1996 to provide specifically that software, except for basic operational programs the price of which is included in the sale or lease price of the computer equipment, shall not be valued for purposes of property taxation.

The County Assessors brought an action to have the amendment to the rule declared invalid as being in violation of the California Constitution and beyond the power of the Board of Equalization. The County Assessors argued that the controlling feature with respect to taxability should be the function of the program, not whether it was "bundled" with the sale of the computer.

The court concluded the amendment to the rule was valid and was within the power delegated by the Legislature to the Board of Equalization. The court reviewed the legislative history of Sections 995 and 995.2 of the Revenue and Taxation Code and found the amendment to the rule consistent with the adoption of these provisions.

The court appeared to be sympathetic to the Assessors' claims that the nature of the industry had changed dramatically in the past twenty years, but found that resolution of their concerns lay with the Legislature, not the courts.

J. States' Sovereign Immunity.

Alden v. *Maine*, 67 USLW 4601.

Petitioners originally filed suit against the State of Maine, their employer, to enforce the overtime provisions of the Fair Labor Standards Act in Federal District Court. This action was dismissed after the decision in *Seminole Tribe of Florida* v. *Florida* (1998) 517 U.S. 44. The action was then filed in state court. The state court dismissed the action on the grounds of sovereign immunity. The Maine Supreme Court and the United States Supreme Court upheld the dismissal.

The Court held that the powers delegated to Congress under Article I of the Constitution do not include the power to subject non-consenting states to private suits for damages in state courts. This right does not, however, confer upon the state a concomitant right to disregard the Constitution or valid federal laws. Sovereign immunity bars a suit only in the absence of consent; consent may arise through the Constitution or its amendments, e.g., the Fourteenth Amendment. Finally, sovereign immunity does not extend to lesser governmental entities or to state officials sued in their individual capacity.

This case would appear to strengthen the likelihood that state claims of sovereign immunity in bankruptcy proceedings will be sustained. Any attempt to overcome sovereign immunity will necessarily focus on whether the bankruptcy act was in any manner adopted pursuant to the Fourteenth Amendment. The case is also likely to give rise to a rash of suits against individuals who are state officials and raise *Ex Parte Young* (1908) 209 U.S. 123, considerations.

Bankruptcy – Suit of a State Official - *Ellett* v. *Goldberg*, 229 Bankruptcy Reporter 202.

Debtor filed a proceeding against the Executive Officer of the Franchise Tax Board seeking a declaration that taxes had been discharged and to

enjoin collection activities with respect to such taxes. The state moved to dismiss. Motion was denied.

The Bankruptcy Court accepted a *Seminole* argument of sovereign immunity but allowed the matter to proceed under the doctrine of *Ex Parte Young* (1908) 209 U.S. 123, as a suit against Goldberg as an individual. The court found that the Bankruptcy Code did not contain a remedial statutory scheme which was available to debtors in the event the state sought to collect discharged taxes. The court also found that the limitations on relief against state officials suggested by *Idaho v. Coeur d'Alene Tribe of Idaho* (1997) 521 U.S. 261, were not applicable.

Bankruptcy Discharge - *Schatz* v. *Franchise Tax Board* (1999) 69 Cal.App.4th 595.

Schatz filed a Chapter 11 proceeding and sought a discharge of state taxes. The Bankruptcy Court decided that the question of the date the taxes were assessed was a question of state law and suggested that the debtor should bring an action on this issue. The action was brought and was defended on the merits in state court. Taxes are not dischargable in bankruptcy if they are assessed within 240 days of the filing of a bankruptcy petition or are assessed after the petition is filed.

The years involved were 1982, 1983, and 1986 to 1990. (It was agreed that assessments for the years 1984 and 1985 were discharged.) An NPA was issued for 1982 on Feb 15, 1990, and the taxpayer filed a timely protest. The parties agreed to the postponement of action on the protest pending consideration of federal issues. In January and April of 1994, the Board received information from the IRS on adjustments for all years. On November 28, 1994, the taxpayer filed amended returns reporting the federal changes. An installment payment plan was agreed to between the taxpayers and the Board. The taxpayers performed pursuant to the plan until they filed their bankruptcy petition.

In order to qualify for discharge, the taxes involved would have had to have been assessed prior to December 3, 1994 (240 days plus 30 days for the offer in compromise).

The Board issued a Notice of Action for 1982 on December 14, 1994, and a statement of tax due on February 11, 1995. On March 25, 1996, the Board posted the amended returns for 1983 and 1986 through 1990 to its accounts and mailed statements of tax due on March 29, 1996.

With respect to 1982, the court held that the tax became due and owing sometime shortly prior to the statement of tax due issued on February 11,

1995. The date of the Notice of Action did not establish that the tax was owed.

With respect to the years 1983 and 1986 through 1990, the filing of the amended returns did not assess the tax. It was the acceptance of those returns as evidenced by the posting of the tax due to the taxpayers' account that assessed the tax.

This decision is not yet final. The taxpayer has filed a petition with the California Supreme Court. While the petition was pending, it converted to a Chapter 13 bankruptcy. The California Supreme Court has taken the position that its consideration of the matter is stayed as a result of the new bankruptcy proceeding. Arguments can be made that there is no stay because this is a proceeding initiated by the debtor, or, alternatively, a request could be filed with the Bankruptcy Court lifting the stay.

Bankruptcy Reports versus Returns - *In re Jackson* v. *Franchise Tax Board*, U.S. Court of Appeals 98-56014.

The Internal Revenue Service reassessed the debtors' federal tax liabilities for the years 1982, 1983 and 1989. The debtors did not notify the Franchise Tax Board of the federal changes as required by California law. The debtors filed for bankruptcy in 1996. The Franchise Tax Board filed a proof of claim based upon the IRS reassessments. The debtors objected to the claim and the Bankruptcy Court allowed their objections. The District Court affirmed that the FTB's claims were discharged as did the Circuit Court of Appeals.

Section 523 of the Bankruptcy Code (11 USC § 532) provides that a tax debt cannot be discharged if the debtor has not filed required "returns." Section 18622 of the Revenue and Taxation Code requires a taxpayer to "report" any federal changes to the Franchise Tax Board. There was no dispute that the taxpayers had failed to report the federal changes to the FTB. The FTB argued on the basis of a New York bankruptcy decision, *In re Blutter*, that a taxpayer should not be allowed to discharge a tax debt where they had not performed the duties required by law. The taxpayers argued, and the Ninth Circuit held, that a "report" is different than a "return." Bankruptcy law imposes a requirement that "returns" be filed in order for taxes to be dischargable, but that a "report" does not rise to the level of a "return."

K. Tax Fraud.

People v. *Hagen* (1998) 19 Cal 4th 652.

The saga of how a California Highway Patrol officer sacrificed himself for the taxpayers of California.

The officer was married to a woman who was embezzling from an insurance agency where she was employed. The embezzled funds apparently were either deposited in the couple's joint checking account or spent as cash by both of them. Joint returns were prepared by a tax preparer, another highway patrol officer, and did not include the embezzled funds. The preparer asked both husband and wife if they had any other income which should be declared. They indicated they did not. The Hagens were prosecuted, and convicted, for three felony offenses of subscribing state tax returns without a belief in the material truth of the returns.

The Supreme Court affirmed the husband's conviction in spite of its determination that the trial judge had erred in not properly instructing the jury. The Supreme Court held that the jury should have been required to find that the prosecution had proved that Hagen had made the perjurious statements in a voluntary and intentional violation of a known legal duty (to report the embezzled funds as income). Nonetheless, the Court found that the weight of the evidence against Hagen was so overwhelming that the error was harmless.

The Supreme Court's decision raises the bar in California (henceforth) so that to convict a person in California of felony tax fraud, the prosecution must prove the defendant's knowledge of the duty to report the unreported income. One suspects that former Officer Hagen has no appreciation of the service he may have performed for other taxpayers.

Attachment 1

The charts below list some of the civil penalty sections of the Sales and Use Tax Law, Personal Income Tax Law, and the Bank and Corporation Tax Law which might have independent grounds, such as reasonable cause, for challenging a penalty assessment.

SALES AND USE TAXES

Violation	Rev. & Tax. Code Section	Relief of Penalties Section
Penalty for Late Pre-Payment	6476	Subject to excusable delay relief (Section 6592)
Penalty for Failure to Prepay When Timely Quarterly Return is Filed	6477	Subject to excusable delay relief (Section 6592)
Failure to File a Return	6511	Subject to excusable delay relief (Section 6592)
Failure to Pay a Determination	6565	Subject to excusable delay relief (Section 6592)
Failure to Pay Tax or Amount of Tax; Late Payment Penalty	6591	Subject to excusable delay relief (Section 6592)
Direct Pay Permit Holders, Failure to Pay Retailers Tax Liability	7051.2	Subject to excusable delay relief (Section 6592)
Negligence/Intentional Disregard of The Law Penalty	6484	Reasonable Cause
Fraud/Intent to Evade Penalty	6485	

INCOME AND FRANCHISE TAXES

Violation	Rev. & Tax. Code Section	Relief of Penalties Section
Failure to Comply With Requirement to Remit Payment by Electronic Funds Transfer	19011	Reasonable Cause
Failure to File Return	19131	Reasonable Cause
Failure to Pay Amount on Return by Due Date or Within 15 Days of Notice and Demand (10 Days for Notices Issued Before 1998)	19132	Reasonable Cause
Failure to Furnish Requested Information or File Return on Notice and Demand by FTB	19133	Reasonable Cause
Failure to Make Small Business Stock Report *	19133.5	Reasonable Cause
Failure to File Return If Corporation Is Doing Business In The State Without Being Qualified **	19135	Reasonable Cause
Failure to Furnish Information Re Foreign Corporations (IRC § 6038) **	19141.2	Reasonable Cause
Failure to Furnish Information Concerning Foreign-Owned Corporations ** (IRC §§ 6038A, B and C)	19141.5	Reasonable Cause
Failure to Maintain Water's-Edge Records **	19141.6	Reasonable Cause
Negligence, Substantial Underpayment, Etc.	19164	Reasonable Cause
Fraud	19164	Reasonable Cause
Various Failures to File Information Return, Provides a Payee Statement or Provide a Written Explanation *	19183	Reasonable Cause
Failure to File Information Report Regarding Individual Retirement Account or Annuity *	19184	Reasonable Cause
Overstatement of Nondeductible IRA Contributions Without Reasonable Cause *	19184	Reasonable Cause

* personal income tax only
** corporation franchise (income) tax only

Attachment 2

Below is a chart listing 1997 and 1998 appeals to the State Board of Equalization that include penalty challenges:

PENALTIES IN APPEALS PENDING
BEFORE THE STATE BOARD OF EQUALIZATION

REV. & TAX CODE SECTION	1997 NO. OF APPEALS	1998 NO. OF APPEALS
19131(late filing)	69	65
19132 (late payment)	41	40
19133 (failure to furnish)	93	88
19133.4-5 (info returns)	1	0
19136, 19142, 19161 (estimated tax)	26	30
19164 (accuracy)	7	6
19011(EFT)	0	0
19141.5 (FF5472)	0	1